BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION

In the Matter of Request for Review	)	
	)	
by Steelville Telephone Exchange, Inc.,	)	CC Docket No. 96-45
of Decision by the Universal Service	)	
Administrative Company	)	

Audit Number: HC-2007-315
SAC Number: 421949

REQUEST FOR REVIEW BY STEELVILLE TELEPHONE EXCHANGE, INC. OF USAC DECISION

Pursuant to Section 54.719 of the Commission's rules, Steelville Telephone Exchange, Inc. ("Company" or "Steelville") hereby seeks review of the decision of the Universal Service Administrative Company (USAC) denying Steelville's appeal of Audit Finding No. 3 contained in the 2007 FCC Office of Inspector General (OIG) audit ("the Audit") conducted by KPMG LLP (KPMG).

I. Introduction and Procedural History

Steelville is a small rural local exchange company (RLEC) providing telephone service in rural Missouri. Steelville has certificate of service authority granted by the Missouri Public Service Commission. Steelville has been providing service in rural Missouri for nearly sixty years, since 1952.

Steelville receives support from the federal Universal Service Fund (USF) High Cost Program. Under the FCC's OIG Audit Program, outside auditor KPMG conducted an audit of Steelville's High Cost Program support from the USF for the 12 month period ending June 30, 2007. In an Audit Report dated January 30, 2009, KPMG described the following Management Finding No. 3:

Finding 3

Condition:

1. The components of the deferred tax liability ("DTL") account of $2,676,738 as of 12/31/04 could not be supported by subsidiary records or other underlying support documentation.
2. A breakout of the 2006 tax accounts between regulated and nonregulated services and appropriate support was not provided.
3. A correction of $1,105,000 was made during 2005 related to unsubstantiated DTL amounts created before 12/31/04 (as represented by the Beneficiary) to reduce the DTL account and recognize a credit to the provision through Account 7450. The credit to the provision was excluded from the 2005 funding for LSS and HCL. The adjusted DTL account was included in the HCL and LSS True-up Forms.
4. Account 7250 – Provision for Deferred Operating Income Taxes is not utilized by the Beneficiary for the deferred portion of the operating income tax provision.

KPMG's finding was disputed by Steelville in its Management Representation Letter dated January 1, 2009, as follows:

> Beneficiary does not agree with KPMG's conclusion and statement that HCL disbursements calculated in the applicable data submissions were $314,000 higher than they would have been had amounts been reported properly. Beneficiary did, in fact, properly report and include the appropriate and correct amount of income taxes attributable to regulated

telephone operating income for the year 2005 as required by the data submission form and, accordingly, HCL disbursements to the Beneficiary were not overstated.

Nevertheless, USAC concurred in the KPMG's finding and sought to recover high cost support from Steelville in the amount of $314,030.

Steelville continued to dispute KPMG's finding and filed a Letter of Appeal with USAC on November 19, 2009. (*See* Attachment A.)

On December 9, 2011, USAC denied Steelville's appeal and determined that $314,030 of previously disbursed High Cost Program support should be recovered. (*See* Attachment B.)

II. Question Presented for Review and Relief Sought

<u>Questions Presented</u>: Did USAC err by affirming KPMG's Finding No. 3?

<u>Relief Sought</u>: Steelville respectfully requests that the Commission reverse USAC's decision affirming KPMG Finding No. 3, confirm Steelville's position as set forth below, and remand this matter to USAC with instructions.

III. Background

During 2005, Steelville changed auditing firms. Shortly thereafter, Steelville and its new auditing firm came to the conclusion that the old auditing firm did not have sufficient workpapers to support the calculation of deferred income taxes reflected in the liabilities of the Company at December 31, 2004. When requested to provide support for the deferred tax calculations, the old auditing firm was not able to provide copies of its calculations. Accordingly, the new auditing firm analyzed prior year's income tax returns and financial records of the Company to determine the amount of tax timing differences that existed at December 31, 2005. The new auditing firm then calculated the appropriate amount of deferred income taxes applicable to the known timing differences at December 31, 2005 in accordance with accounting standards under FASB 109. They also determined the amount of the originating and reversing differences applicable to the year 2005 in order to determine the appropriate amount of timing differences and deferred income tax liability that should have been applicable at December 31, 2004.

As a result of these calculations, the new auditing firm determined an adjustment to deferred taxes applicable to 2004 and prior years was necessary in the amount of $1,105,000. An adjustment of $1,105,000 was thus recorded on the books of Steelville during 2005 to reduce the Company's deferred tax liability as of December 31, 2004.

IV. Steelville's Position

The taxes recorded on Steelville's books do not reflect the impacts of cost study adjustments or non-regulated expense reclassifications performed in conjunction with the annual cost study. Instead, Steelville applies an effective tax rate to its regulated taxable income, after cost study adjustments, to determine the appropriate amount of income taxes for its cost study filings and USF data submissions. Steelville's method of income tax recognition automatically takes into effect the tax impacts of cost study adjustments and adjustments for non-regulated activities that are performed with the Company's annual cost study.

In response to KPMG's finding that Steelville does not recognize deferred income taxes in Account 7250 in its USF data submissions, Steelville asserts that its income tax calculation reflects a combination of both operating and deferred income tax expense applicable for the reporting period based on the Company's adjusted book taxable income for the reporting period. The calculated tax amount is used in lieu of the Company's recorded income tax expenses that do not reflect the tax effects of cost study adjustments and non-regulated activities. Steelville does reflect deferred income tax expenses in its USF data submissions. Deferred income taxes comprise a component of its calculated income taxes using the effective tax rate methodology applied to book basis taxable income.

To demonstrate the Company's income tax methodology used for cost study purposes, the Company prepared a schedule reflecting the calculation of its operating tax expense for the years 2001 through 2005 which was attached to the Company's USAC Appeal Letter and is reproduced and attached hereto as Attachment C. Attachment C provides the calculation of Federal and State income tax expense based on the Company's regulated taxable income reported for cost study purposes. To these amounts, the Company adds other operating taxes (which are comprised mostly of property tax expenses) to arrive at total Operating Taxes. The Company's calculated Operating Taxes are then used in the Company's USF data collections in lieu of the recorded amounts of income taxes in Account 7200. A comparison of the calculated tax expense with the amounts reported on the Company's USF data collections for the years 2001 through 2005 is provided on Attachment C.

As indicated on Attachment C, Steelville has claimed $5,664,079 of tax expense on its USF data submissions for the years 2001 through 2005. Steelville's calculated tax amounts for the same periods amount to $6,061,407, resulting in an <u>underreporting of tax expense</u> for USF purposes of $397,328 for the years 2001 through 2005.

Steelville is not requesting recovery of additional tax expenses in this appeal for reversal of audit Finding No. 3. Steelville is merely presenting the tax expense reported to USAC for the years 2001 through 2005 to show that its tax reporting procedures are applied consistently for each of the years and that the reported tax amounts are reasonably stated based on the regulated taxable income for each of the reporting periods.

The position taken by KPMG is that the Company failed to reflect recorded tax amounts in Steelville's USF data submissions. The Company believes that the aforementioned position taken by KPMG is contrary to positions taken in other USAC audits when the recorded income tax amounts did not provide a reasonable result based on the calculation of an effective tax rate for the reporting period. KPMG's position in Steelville's audit does not produce a reasonable result and is not consistent with prior year's income tax reporting by the Company in its cost studies and USF data submissions. Furthermore, in order to accept KPMG's position, there would have to have been an overreporting of income tax expense in the Company's cost studies and USF data submissions in prior years, which is not the case based on the Company's tax recognition procedures. The overstatement of deferred income taxes on the books of the Company occurred during 2001 through 2004, but, significantly, it was <u>not</u> reflected in the USF data submissions filed by the Company for those years. Again, as can clearly be seen from Attachment C, the income tax expense (and deferred tax) amounts on Steelville's books for years 2001 through 2004 are unrelated to the amount of income tax expense reported to USAC and upon which High Cost Support was based. In fact, a comparison of the tax expense recorded per books with the amounts recognized on the USF data collection forms for the years 2001 through 2005 shows that the original tax expense overstatement (error) was not reported or recovered through USAC's support programs and thereby supports the argument that the correction of the prior year tax expense error should not be reported ~~corded~~ or recovered through USAC's support programs as well.

Furthermore, KPMG has not proven that its Finding No. 3 produces a reasonable result when determining an effective tax rate for the year 2005. Steelville asserts that KPMG's effective tax rate for the year 2005, based on recorded tax expenses, is a negative 3.09%, which is materially understated and produces an unreasonable result by including the correcting entry for the reversal of prior year income tax expenses recorded in error. (*See* Attachment D hereto which calculates the effective tax rate for 2005). Imputed taxes based on an effective tax rate should be used in lieu of the recorded amounts when the recorded amounts do not produce a reasonable amount of income tax expense for the cost study reporting period. Steelville has consistently used the same income tax recognition procedures for its cost studies and USF data submissions for each of the years 2001 through 2005, thereby negating the recovery of erroneous income tax expenses recorded in prior years.

Finally, on information and belief, subsequent KPMG audit teams have reviewed other USF Beneficiaries with similar tax issues as Steelville. And, in those audits, the KPMG audit team accepted the approach used and advocated by Steelville and made no similar findings or recommendations in those subsequent audits. Steelville has attempted to contact KPMG to verify this situation but representatives of KPMG were reluctant to talk with Steelville's representatives. If Steelville is correct, then KPMG's finding in this case raises questions of fundamental fairness and consistency. Accordingly, Steelville requests that the FCC contact KPMG directly and request that it confirm or deny that it has handled this issue differently for other beneficiaries in audits subsequent to its audit of Steelville.

V. Summary and Conclusion

Steelville's methodology of reporting income tax expenses for cost study purposes is appropriate and complies with all rules and regulations promulgated by the FCC. The amounts used by Steelville in its cost studies reflect the amount of income tax expense that is applicable to the Company's regulated operations for the reporting period. The reasonableness of the Company's income tax expense reported for each of the years 2001 through 2005 can be determined by calculating an effective tax rate for each year. KPMG's effective tax rate of a <u>negative</u> 3.09% for the year 2005 is materially understated, based on the amounts recorded on the Company's books due to a reversal of prior year deferred tax errors. Steelville also submits that the erroneous deferred tax expense amounts recognized by its old auditing firm in prior years were not reflected in Steelville's USF data submissions, because the Company used the same effective tax rate procedures to calculate income taxes in those years as well.

For all the reasons cited above, Steelville respectfully requests that the FCC reverse USAC's Finding No. 3 included in its Management Response and rescind its request for recovery of the USF impact of this Finding in the amount of $314,030.

Respectfully submitted,

By: **/s/ W.R. England, III**
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Attorneys for Steelville

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the above and foregoing document was sent by U.S. Mail, postage prepaid, or hand-delivered on this 3rd day of February, 2012, to the following parties:

Universal Service Administrative Company
Billing, Collections, and Disbursements
2000 L. Street, NW, Suite 200
Washington, DC 20036

/s/ W.R. England, III

ATTACHMENT A – STEELVILLE TELEPHONE EXHANGE LETTER OF APPEAL

Attachment A

STE Communications

"Tomorrow's Services Today"

61 E. Hwy. 8
P.O. Box 370
Steelville, MO 65565
573-775-2111 • Fax 573-775-5910 • www.misn.com

- Steelville Telephone Exchange, Inc.
- STE Rural Development, Inc.
- Steelville Long Distance, Inc.
- MISNet

November 19, 2009

Letter of Appeal
High Cost & Low Income Division
Universal Service Administrative Company
2000 L Street, NW
Suite 200
Washington, DC 20036

Re: High Cost Appeal
Steelville Telephone Exchange, Inc.
(Audit Number: HC-2007-315)
(SAC Number: 421949)

To Whom It May Concern:

Please consider this Steelville Telephone Exchange, Inc.'s (Steelville or Company) appeal of the Universal Service Administrative Company's (USAC) Management Response issued in the above-referenced audit on August 3, 2009 (and received by Steelville on or about October 1, 2009). Specifically, Steelville seeks appeal of the USAC Management Response Finding No. 3 which was described in the KPMG LLP (KPMG) Independent Accountant's Report, dated January 30, 2009, as follows:

<u>Finding 3</u>
Condition:

1. The components of the deferred tax liability ("DTL") account of $2,676,738 as of 12/31/04 could not be supported by subsidiary records or other underlying support documentation.

2. A breakout of the 2006 tax accounts between regulated and nonregulated services and appropriate support was not provided.

3. A correction of $1,105,000 was made during 2005 related to unsubstantiated DTL amounts created before 12/31/04 (as represented by the Beneficiary) to reduce the DTL account and recognize a credit to the provision through Account 7450. The credit to the provision was excluded from the 2005 funding for LSS and HCL. The adjusted DTL account was included in the HCL and LSS True-up Forms.

4. Account 7250 – Provision for Deferred Operating Income Taxes is not utilized by the Beneficiary for the deferred portion of the operating income tax provision.

KPMG's finding was disputed by Steelville in its Management Representation Letter dated January 1, 2009, as follows:

> Beneficiary does not agree with KPMG's conclusion and statement that HCL disbursements calculated in the applicable data submissions were $314,000 higher than they would have been had amounts been reported properly. Beneficiary did, in fact, properly report and include the appropriate and correct amount of income taxes attributable to regulated telephone operating income for the year 2005 as required by the data submission form and, accordingly, HCL disbursements to the Beneficiary were not overstated.

Nevertheless, USAC concurred in the KPMG's finding and now seeks to recover high cost support from Steelville in the amount of $314,030. Steelville continues to dispute this finding and, in support of its appeal, respectfully submits the following additional information.

Background

During 2005, Steelville changed auditing firms. Shortly thereafter, Steelville and its new auditing firm came to the conclusion that the old auditing firm did not have sufficient workpapers to support the calculation of deferred income taxes reflected in the liabilities of the Company at December 31, 2004. When requested to provide support for the deferred tax calculations, the old auditing firm was not able to provide copies of its calculations. Accordingly, the new auditing firm analyzed prior year's income tax returns and financial records of the Company to determine the amount of tax timing differences that existed at December 31, 2005. The new auditing firm then calculated the appropriate amount of deferred income taxes applicable to the known timing differences at December 31, 2005 in accordance with accounting standards under FASB 109. They also determined the amount of the originating and reversing differences applicable to the year 2005 in order to determine the appropriate amount of timing differences and deferred income tax liability that should have been applicable at December 31, 2004. As a result of these calculations, the new auditing firm determined an adjustment to deferred taxes applicable to 2004 and prior years was necessary in the amount of $1,105,000. An adjustment of $1,105,000 was thus recorded on the books of Steelville during 2005 to reduce the Company's deferred tax liability as of December 31, 2004.

Steelville Position

The taxes recorded on Steelville's books do not reflect the impacts of cost study adjustments or non-regulated expense reclassifications performed in conjunction with the annual cost study. Instead, Steelville applies an effective tax rate to its regulated taxable income, after cost study adjustments, to determine the appropriate amount of income taxes for its cost study filings and USF data submissions. Steelville's method of income tax recognition automatically takes into effect the tax impacts of cost study adjustments and adjustments for non-regulated activities that are performed with the Company's annual cost study. In response to KPMG's finding that Steelville does not recognize deferred income taxes in Account 7250 in its USF data submissions, Steelville asserts that its income tax calculation reflects a combination of both operating and deferred income tax expense applicable for the reporting period based on the Company's adjusted book taxable income for the reporting period. The calculated tax amount is used in lieu of the Company's recorded income tax expenses that do not reflect the tax effects of cost study adjustments and non-regulated activities. Steelville does reflect deferred income tax expenses in its USF data submissions. Deferred income taxes comprise a component of its calculated income taxes using the effective tax rate methodology applied to book basis taxable income.

To demonstrate the Company's income tax methodology used for cost study purposes, the Company has prepared a schedule reflecting the calculation of its operating tax expense for the years 2001 through 2005 on Attachment 1 to this letter. Attachment 1 provides the calculation of Federal and State income tax expense based on the Company's regulated taxable income reported for cost study purposes. To these amounts, the Company adds other operating taxes (which are comprised mostly of property tax expenses) to arrive at total Operating Taxes. The Company's calculated Operating Taxes are then used in the Company's USF data collections in lieu of the recorded amounts of income taxes in Account 7200. A comparison of the calculated tax expense with the amounts reported on the Company's USF data collections for the years 2001 through 2005 is provided on Attachment 1. As indicated on the Attachment, Steelville has claimed $5,664,079 of tax expense on its USF data submissions for the years 2001 through 2005. Steelville's calculated tax amounts for the same periods amount to $6,061,407, resulting in an underreporting of tax expense for USF purposes of $397,328 for the years 2001 through 2005. Steelville is not requesting recovery of additional tax expenses in this appeal for reversal of audit Finding No. 3. Steelville is merely presenting the tax expense reported to USAC for the years 2001 through 2005 to show that its tax reporting procedures are applied consistently for each of the years and that the reported tax amounts are reasonably stated based on the regulated taxable income for each of the reporting periods.

The position taken by KPMG is that the Company failed to reflect recorded tax amounts in Steelville's USF data submissions. The Company understands the position taken by KPMG, but KPMG's position does not produce a reasonable result and is not consistent with prior year's income tax reporting by the Company. In order for USAC to accept KPMG's position, there would have to have been an overreporting of income tax expense in prior years, which is not the case based on the Company's tax recognition procedures. Furthermore, KPMG has not proven that its Finding No. 3 produces a reasonable result when determining an effective tax rate for the year 2005. Steelville asserts that KPMG's effective tax rate for the year 2005, based on recorded tax expenses, is a negative 3.09%, which is materially understated and produces an unreasonable result (see Attachment 2 which calculates the effective tax rate for 2005). Imputed taxes based on an effective tax rate should be used in lieu of the recorded amounts when the recorded amounts do not produce a reasonable amount of income tax expense for the cost study reporting period. Furthermore, Steelville has consistently used the same income tax recognition procedures for each of the years 2001 through 2005.

Summary

In summary, Steelville's methodology of reporting income tax expenses for cost study purposes is appropriate and complies with all rules and regulations promulgated by the FCC. The amounts used by Steelville in its cost studies reflect the amount of income tax expense that is applicable to the Company's regulated operations for the reporting period. The reasonableness of the Company's income tax expense reported for each of the years 2001 through 2005 can be determined by calculating an effective tax rate for each year. KPMG's effective tax rate of a negative 3.09% for the year 2005 is materially understated, based on the amounts recorded on the Company's books due to a reversal of prior year deferred tax errors. Steelville also submits that the erroneous deferred tax expense amounts recognized by its old auditing firm in prior years were not reflected in Steelville's USF data submissions, because the Company used the same effective tax rate procedures to calculate income taxes in those years as well.

For all the reasons cited above, Steelville respectfully requests that USAC reverse its Finding No. 3 included in its Management Response and rescind its request for recovery of the USF impact of this Finding in the amount of $314,030.

Please direct any correspondence and/or communication regarding this appeal as follows:

Mr. Don Santhuff
Steelville Telephone Exchange, Inc.
P.O. Box 370
61 East Hwy. 8
Steelville, MO 65565
573/775-2111 (Tele #)
573/775-5910 (Fax #)
Email: santhuff@misn.com

With copies to our Cost Consultant:

Jack Carter
Director – Client Services
Beacon, LLC
8801 S. Yale Ave., Suite 450
Tulsa, OK 74137
918/496-1444 (Tele #)
918/496-7733 (Fax #)
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and to our Attorney:

W.R. (Trip) England, III
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Sincerely,

Donald R. Santhuff
General Manager

Steelville Telephone Exchange

Attachment 1

Operating Income Tax Calculation

For the Five Study Years Ending 12/31/05

		2005	2004	2003	2002	2001	
Regulated Telco Revenues:							
Local Network Revenues		$ 3,128,987	$ 2,870,611	$ 2,622,108	$2,977,130	$ 2,315,608	
Network Access Services Revenues		4,085,606	4,046,930	3,992,496	3,948,735	3,264,576	
Long Distance Message Revenue		1,211	7,339	13,713	31,341	(17,355)	
Directory and Rent Revenues		78,485	56,527	45,876	39,474	49,284	
Miscellaneous Revenues		159,637	24,260	22,693	27,013	22,577	
Carrier Billing & Collection Revenue		105,280	111,546	113,927	101,032	135,123	
Uncollectibles							
		7,559,206	7,117,213	6,810,813	7,124,725	5,769,813	
Regulated Telco Costs and Expenses:							
Network Support Expense		6,936	10,406	5,148	9,049	2,590	
General Support Expenses		172,924	126,153	124,725	125,349	106,001	
Total Central Office Expense		432,934	343,771	317,464	255,237	304,219	
Total C&WF Expense		326,047	340,920	237,176	212,652	207,787	
Other P.P.&E. Expense		16,312	20,303	15,767	18,344	72,946	
Network Operations Expense		256,531	272,246	222,621	232,182	180,073	
Access Expense		51,178	42,886	33,171	19,311	8,293	
Depr. & Amort. Expense		1,426,255	1,416,891	1,449,459	1,321,160	1,213,739	
Total Customer Services		261,004	277,832	287,285	285,079	328,338	
Executive & Planning		282,352	283,256	247,949	231,106	180,697	
General & Administrative		655,221	619,873	654,839	524,156	616,103	
Other Operating Taxes		314,285	281,910	276,229	243,296	212,151	
Total Interest and Related Items		512,162	539,213	562,633	559,182	514,228	
Non-operating Interest and Related Items		(199,178)	(207,814)	(195,279)	(160,002)	(157,951)	
Special Charges - Allowed Portion		165,569	98,432	118,703	192,649	149,807	
		4,680,532	4,466,278	4,357,890	4,068,750	3,939,021	
Regulated Telco Pretax Operating Income		2,878,674	2,650,935	2,452,923	3,055,975	1,830,792	
Operating Income Taxes:							
Federal Income Tax	34.00%	937,499	863,331	798,845	995,241	596,235	
State Income Tax	6.25%	121,323	111,725	103,380	128,796	77,160	
		1,058,823	975,057	902,225	1,124,037	673,395	
Other taxes - (Primarily property taxes)		314,285	281,910	276,229	243,296	212,151	
Taxes for USF - Line 650 USF Data Submission		1,373,108	1,256,966	1,178,454	1,367,333	885,546	
Taxes reported on USF Data Submissions		1,331,624	1,224,103	1,429,914	1,115,758	562,680	
Taxes under (over) stated on USF Data Submission.		$ 41,484	$ 32,863	$ (251,460)	$ 251,575	$ 322,866	5 Year Total 397,327
USF Settlements Impact - Over (Under) Stated		$ (23,460)	$ (18,547)	$ 141,427	$ (141,424)	$ (189,730)	5 Year Total (231,734)
Year end Deferred Tax Liability		$ 1,571,100	$ 2,676,738	$ 2,417,733	$ 1,470,608	$ 1,311,642	

Steelville Telephone Exchange **Attachment 2**

Calculation of Effective Operating Income Tax Rate for 2005
Utilizing Recorded Operating Income Tax Expense per KPMG

Operating Federal IncomeTaxes	$ 897,377
Operating State Income Taxes	119,962
Sub Total Current Operating Income Taxes	1,017,339
Deferred Income Taxes Provision (Benefit)	(1,105,638)
Total Operating Income Tax Expense (Benefit)	$ (88,299)
Regulated Taxable Operating Income - Per Attachment	$ 2,878,674
Effective Operating Income Tax Rate (Negative)	(3.09)%

ATTACHMENT B – USAC DECISION

USAC
Universal Service Administrative Company

Administrator's Decision on High Cost Program Beneficiary Appeal

Via Email and Certified Mail

December 9, 2011

Mr. Donald R. Santhuff
Steelville Telephone Exchange, Inc.
61 East Hwy. 8
Steelville, MO 65565

Re: Appeal of the 2007 FCC Office of Inspector General USF Audit Program Audit of High Cost Program Beneficiary: Steelville Telephone Exchange, Inc. (SAC 421949), Audit HC-2007-BE315

Dear Mr. Santhuff:

The Universal Service Administrative Company (USAC) has reviewed the appeal you filed on behalf of Steelville Telephone Exchange, Inc. (Steelville), dated November 19, 2009, concerning USAC's decision to recover $314,030 in previously paid High Cost Program support disbursed for the 12-month period ending June 30, 2007. The recovery amount was determined by an audit of Steelville conducted by KPMG LLP (the auditors), under the FCC Office of Inspector General (OIG) Universal Service Fund (USF) Audit Program.

Steelville appealed the results of finding HC2007BE315-F03 and requested that USAC rescind its decision to recover this support. Steelville asserted that the application of an effective tax rate to its regulated taxable income, after cost study adjustments, results in the correct income tax amount for cost study filings and High Cost Program data submissions.

Decision on Appeal: Denied. USAC has determined that $307,268 of previously disbursed High Cost Program support should be recovered.

Background and Discussion

Steelville appealed the auditors' finding HC2007BE315-F03 that the components of the deferred tax liability (DTL) and the breakout of regulated/non-regulated tax accounts could not be supported by subsidiary records or supporting documentation.[1] In its appeal, Steelville conceded that its books do not reflect the impacts of cost study adjustments or

[1] Letter from Donald Santhuff for Steelville Telephone Exchange, Inc., to High Cost and Low Income Division, USAC, dated Nov. 19, 2009 (*Steelville Appeal Letter*).

non-regulated expense reclassifications. Steelville argued, however, that it applies an effective tax rate to its regulated taxable income after cost study adjustments to calculate the correct level of income tax for its regulatory reporting.[2] Moreover, Steelville claims that its method of income tax recognition accounts for the tax impacts of cost study adjustments and adjustments for non-regulated services, which are accounted for in the company's annual cost study.[3] Steelville argues that the income tax calculation used in its corporate financial reporting, which utilizes a combination of operating and deferred tax expense, develops the correct valuation for the applicable reporting period. Steelville asserts that its methodology calculated reasonable reporting levels.[4]

The auditors determined that Steelville's usage of the effective rate on regulated taxable income is non-compliant with the valid deferred tax liability valuation because FCC rules require the provisioning of the actual current portion of deferred operating income taxes.[5] Further, the auditors concluded that Steelville's processes lacked adequate internal controls necessary to account for DTL on its books, and Steelville neglected to allocate tax accounts between regulated and non-regulated activities on a quarterly basis as required for High Cost Loop filings.[6] Pursuant to this audit finding, the auditors recommended that USAC disallow the excess DTL reported by Steelville and further recommended recovery of $314,030 in High Cost Program support previously paid to Steelville.[7]

USAC concurs with the auditors' finding that Steelville's usage of the effective rate on regulated taxable income is non-compliant with FCC regulations. Steelville's methodology deviates from Commission rules because it fails to properly account for the valuations in a correct regulatory manner. In fact, the auditors' subsequent review of these beneficiary responses re-asserted that Steelville's process is not compliant with FCC rules; therefore, the auditors' calculated adjustment to 2005 operating taxes is valid.[8]

Commission rule 47 C.F.R. § 32.14(c) states that when common assets are used in the generation of both regulated and non-regulated costs, the associated assets and expenses must be recorded in subsidiary ledgers based solely on the assignable activity (i.e. assets

[2] *Steelville Appeal Letter*, page 3.
[3] *Id.*
[4] *Steelville Appeal Letter*, page 3.
[5] Letter and Independent Accountants Report No. HC2007BE315 from KPMG LLP to Steelville Telephone Exchange, Inc., dated Jan. 30, 2009, page 6 (*Independent Accountants Report).*
[6] *Id.*
[7] *Independent Accountants Report*, page 7. KPMG determined the following overpayments to Steelville of High Cost Program support components related to erroneous reporting of deferred tax liability: High Cost Loop (HCL): $314,030; Interstate Common Line Support (ICLS) and Local Switching Support (LSS) (2005 data) had no quantifiable impact. Total High Cost recovery for this finding is $314,030.
[8] *Independent Accountants Report*, page 8.

and expenses must be directly assigned to regulated and non-regulated accounts).[9] If the costs are not directly assignable, then 47 C.F.R. § 64.901(a)[10] states that "carriers...shall use the attributable cost method of cost allocation." The accounting for DTL was deficient because Steelville neglected to adequately separate regulated costs; further, the company did not properly account for specific valuations in subsidiary records either through direct assignment or an attributable method of cost allocation as directed by Commission rules.[11] The correct accounting for the deferred income taxes would have been to record them in Provision for Deferred Operating Income Taxes (Account 7250) as required by 47 C.F.R. § 32.7250.[12] That process would have taken the results of the previously cited Part 64 separations and reported the regulated portion for universal service support recovery.

In addition to the issues with the proper treatment of common assets described above, the auditors explained that 47 C.F.R. § 32.22 requires that companies maintain subsidiary records for their deferred tax assets so that sufficient detail exists to understand the reason behind shifts in the individual account balances.[13] The processes utilized by Steelville neglected to establish the subsidiary records necessary to account for the reduction of the deferred tax asset; therefore, Steelville's books lacked the detail to support the deferred

[9] 47 C.F.R. § 32.14(c). ("In the application of detailed accounting requirements contained in this part, when a regulated activity involves the common or joint use of assets and resources in the provision of regulated and non-regulated products and services, companies shall account for these activities within the accounts prescribed in this system for telephone company operations. Assets and expenses shall be subdivided in subsidiaries records among amounts solely assignable to non-regulated activities, amounts solely assignable to regulated activities and amounts related to assets used and expenses incurred jointly or in common, which will be allocated between regulated and non-regulated activities. Companies shall submit reports identifying regulated and non-regulated amounts in the manner and at the times prescribed by this Commission. Non-regulated revenue items not qualifying for incidental treatment, as provided in Sec. 32.4999(1) shall be recorded in Account 5280, Non-regulated operating revenue.").

[10] 47 C.F.R. § 64.901 ("Allocation of costs. (a) Carriers required to separate their regulated costs from non-regulated costs shall use the attributable cost method of cost allocation for such purpose.").

[11] *Independent Accountants Report*, page 7.

[12] 47 C.F.R. § 32.7250 ("Provision for deferred operating income taxes–net. (a) This account shall be charged or credited, as appropriate, *with contra entries* recorded to the following accounts for income tax expense that has been deferred in accordance with § 32,22 of Subpart B.

4100 Net Current Deferred Operating Income Taxes
4340 Net Noncurrent Deferred Operating Income Taxes

(b) Subsidiary record categories shall be maintained to distinguish between property and nonproperty related deferrals and so that the company may separately report that amounts contained herein that relate to Federal, state and local income taxes. Such subsidiary record categories shall be reported by Part 43 of this Commission's Rules and Regulations.").

[13] 47 C.F.R. §32.22. ("Comprehensive inter-period tax allocation. (c) Subsidiary records shall be used to reduce the deferred tax assets contained in the accounts specified in paragraph (a) of this section when it is likely that some portion or all of the deferred tax asset will not be realized. The amount recorded in the subsidiary record should be sufficient to reduce the deferred tax asset to the amount that is likely to be realized. (d) The records supporting the activity in the deferred income tax accounts shall be maintained in sufficient detail to identify the nature of the specific temporary differences giving rise to both the debits and credits to the individual accounts.").

tax accounts balances.[14] Based on the KPMG analysis, USAC concurs with this audit finding and will recover High Cost Program support associated with this finding in the amount of $314,030.

USAC Action and Steelville Appeal Rights

In its appeal letter to USAC, Steelville did not appeal the results of HC2007BE315-F01, F02, F04, F05, or C01-05 with a combined monetary effect of an underpayment of $6,762.

USAC denies Steelville's appeal and will recover $307,268[15] in previously paid High Cost Program support within sixty (60) days of the receipt of this decision through the monthly disbursement process. If the recovery amount exceeds the current month's disbursement, USAC will continue to net the recovery amount against subsequent monthly disbursements. USAC may in its discretion and at anytime issue an invoice for all or a portion of the amount to be recovered. If any further errors are found in Steelville's reporting for the period under audit herein, USAC reserves the right to recover the financial impact of those deviations.

If you wish to appeal this decision, you may file an appeal pursuant to the requirements of 47 C.F.R Part 54, Subpart I. Detailed instructions for filing appeals are available at:

http://www.usac.org/hc/about/filing-appeals.aspx.

//s// Universal Service Administrative Company

[14] *Independent Accountants Report*, pages 6-7.
[15] Recovery amount is $307,268 = $314,030 – $6,762.

ATTACHMENT C – OPERATING INCOME TAX CALCULATION

Attachment C

Steelville Telephone Exchange

Operating Income Tax Calculation

For the Five Study Years Ending 12/31/05

		2005	2004	2003	2002	2001	
Regulated Telco Revenues:							
Local Network Revenues		$ 3,128,987	$ 2,870,611	$ 2,622,108	$ 2,977,130	$ 2,315,608	
Network Access Services Revenues		4,085,606	4,046,930	3,992,496	3,948,735	3,264,576	
Long Distance Message Revenue		1,211	7,339	13,713	31,341	(17,355)	
Directory and Rent Revenues		78,485	56,527	45,876	39,474	49,284	
Miscellaneous Revenues		159,637	24,260	22,693	27,013	22,577	
Carrier Billing & Collection Revenue		105,280	111,546	113,927	101,032	135,123	
Uncollectibles							
		7,559,206	7,117,213	6,810,813	7,124,725	5,769,813	
Regulated Telco Costs and Expenses:							
Network Support Expense		6,936	10,406	5,148	9,049	2,590	
General Support Expenses		172,924	126,153	124,725	125,349	106,001	
Total Central Office Expense		432,934	343,771	317,464	255,237	304,219	
Total C&WF Expense		326,047	340,920	237,176	212,652	207,787	
Other P.P.&E. Expense		16,312	20,303	15,767	18,344	72,946	
Network Operations Expense		256,531	272,246	222,621	232,182	180,073	
Access Expense		51,178	42,886	33,171	19,311	8,293	
Depr. & Amort. Expense		1,426,255	1,416,891	1,449,459	1,321,160	1,213,739	
Total Customer Services		261,004	277,832	287,285	285,079	328,338	
Executive & Planning		282,352	283,256	247,949	231,106	180,697	
General & Administrative		655,221	619,873	654,839	524,156	616,103	
Other Operating Taxes		314,285	281,910	276,229	243,296	212,151	
Total Interest and Related Items		512,162	539,213	562,633	559,182	514,228	
Non-operating Interest and Related Items		(199,178)	(207,814)	(195,279)	(160,002)	(157,951)	
Special Charges - Allowed Portion		165,569	98,432	118,703	192,649	149,807	
		4,680,532	4,466,278	4,357,890	4,068,750	3,939,021	
Regulated Telco Pretax Operating Income		2,878,674	2,650,935	2,452,923	3,055,975	1,830,792	
Operating Income Taxes:							
Federal Income Tax	34.00%	937,499	863,331	798,845	995,241	596,235	
State Income Tax	6.25%	121,323	111,725	103,380	128,796	77,160	
		1,058,823	975,057	902,225	1,124,037	673,395	
Other taxes - (Primarily property taxes)		314,285	281,910	276,229	243,296	212,151	
Taxes for USF - Line 650 USF Data Submission		1,373,108	1,256,966	1,178,454	1,367,333	885,546	
Taxes reported on USF Data Submissions		1,331,624	1,224,103	1,429,914	1,115,758	562,680	
Taxes under (over) stated on USF Data Submission.		$ 41,484	$ 32,863	$ (251,460)	$ 251,575	$ 322,866	**5 Year Total** 397,327
USF Settlements Impact - Over (Under) Stated		$ (23,460)	$ (18,547)	$ 141,427	$ (141,424)	$ (189,730)	**5 Year Total** (231,734)
Year end Deferred Tax Liability		$ 1,571,100	$ 2,676,738	$ 2,417,733	$ 1,470,608	$ 1,311,642	

ATTACHMENT D

CALCULATION OF EFFECTIVE OPERATING INCOME TAX RATE FOR 2005

Attachment D

Steelville Telephone Exchange

Calculation of Effective Operating Income Tax Rate for 2005
Utilizing Recorded Operating Income Tax Expense per KPMG

Operating Federal IncomeTaxes	$ 897,377
Operating State Income Taxes	119,962
Sub Total Current Operating Income Taxes	1,017,339
Deferred Income Taxes Provision (Benefit)	(1,105,638)
Total Operating Income Tax Expense (Benefit)	$ (88,299)
Regulated Taxable Operating Income - Per Attachment	$ 2,878,674
Effective Operating Income Tax Rate (Negative)	(3.09)%

ATTACHMENT E – DECLARATION OF DONALD SANTHUFF

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION

In the Matter of Request for Review by Steelville Telephone Exchange, Inc., of Decision by the Universal Service Administrative Company	)))))	CC Docket No. 96-45

Audit Number: HC-2007-315
SAC Number 421949

DECLARATION OF DONALD R. SANTHUFF

1. My name is Donald R. Santhuff. I am the General Manager of Steelville Telephone Exchange, Inc. My business address is 61 East Highway 8, Steelville, MO 65565. I have reviewed the foregoing "Request for Review by Steelville Telephone Exchange, Inc. of USAC Decision" and the statements made therein are true and correct.

2. Steelville is a small rural local exchange company (RLEC) providing telephone service in rural Missouri. Steelville has certificate of service authority granted by the Missouri Public Service Commission. Steelville has been providing service in rural Missouri for nearly sixty years, since 1952.

3. The USAC Decision, if not reversed or rescinded, will have a significant adverse affect on Steelville's efforts to provide broadband and telecommunications services to rural Missouri. I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct to the best of my information and belief.

Executed on FEBRUARY 3, 2012

Donald R. Santhuff
General Manager

Steelville Telephone Exchange, Inc.
61 East Highway 8
Steelville, MO 65565